In the Supreme Court of the United States

OCTOBER TERM, 1972

No. 72-96

MEMPHIS LIGHT, GAS AND WATER DIVISION, PETITIONER

v.

FEDERAL POWER COMMISSION, ET AL.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT

BRIEF FOR THE FEDERAL POWER COMMISSION IN OPPOSITION

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. A1–A23) is not yet reported. The opinion of the Federal Power Commission (Pet. App. B1–B4) is reported at 43 FPC 740, and its order denying rehearing (Pet. App. B5–B9) is reported at 44 FPC 16.

JURISDICTION

The judgment of the court of appeals was entered on February 18, 1972. On May 11, 1972, the Chief Justice granted an extension of time for the filing of a petition for a writ of certiorari to July 17, 1972,

and on that date the petition was filed. The jurisdiction of this Court is invoked under 28 U.S.C. 1254, and Section 19(b) of the Natural Gas Act, 15 U.S.C. 717r(b).

QUESTION PRESENTED

Whether Section 441(a) of the Tax Reform Act of 1969 deprives the Federal Power Commission of authority to impute the use of liberalized depreciation with flow-through with respect to post-1969 expansion property for calculating the allowance for federal income taxes in ratemaking to a utility making the election under Section 441(a) of the Act to abandon that method of accounting with respect to such property for tax purposes.

STATUTES INVOLVED

Section 441(a) of the Tax Reform Act of 1969, 26 U.S.C. 167(*l*), is set forth at Pet. App. C.

STATEMENT

Section 441(a) of the Tax Reform Act of 1969 provides in part that, with respect to "post 1969" public utility expansion property,[1] a utility using flow-through, as opposed to normalized, accounting[2] could, within 180 days after the date of enactment, elect to abandon

[1] Under 26 U.S.C. 167(*l*)(3)(B) and (C) "post-1969" public utility property is property acquired on or after January 1, 1970. "Expansion property," as used herein, refers to the specification in 26 U.S.C. 167(*l*)(4)(A) of "property which increases the productive or operational capacity of the taxpayer * * * and does not represent the replacement of existing capacity."

[2] Utilities are entitled to include their federal income taxes as an expense in establishing their rates. The method of calculating such taxes for ratemaking purposes, however, may not be the

flow-through. 26 U.S.C. 167 (*l*) (4) (A). Upon exercise of the utility's election to do so, the flow-through method of accounting with respect to post-1969 expansion property would cease to be a method resulting in a "reasonable allowance" for tax depreciation within the meaning of Section 167(a) of the Internal Revenue Code. Under another provision of Section 441(a) of the Act, the utility would be limited to the use of straight-line depreciation or liberalized depreciation with normalization in calculating its depreciation deduction for tax purposes. 26 U.S.C. 167(*l*) (2). To use normalization, however, a utility would have to obtain the authorization of the appropriate regulatory agency.

On May 15, 1970, the Commission issued Order No. 404 (Pet. App. B1–B4) setting forth its policy with respect to Section 441(a) of the 1969 Act. The Commission recognized that, with respect to post-1969 expansion property, a utility using flow-through accounting could abandon that method and, upon doing

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same method used for calculating the taxes actually paid. Under flow-through, a utility using liberalized or accelerated depreciation in calculating its actual taxes, also uses liberalized depreciation in calculating its tax expense for ratemaking purposes. Actual tax savings are thus "flowed-through" to the utility's customers. Under normalization, taxes for ratemaking purposes are computed using straight-line depreciation although the utility uses liberalized depreciation in calculating the taxes it actually pays. The difference between the taxes that would have been paid under straight-line depreciation and the actual taxes based on liberalized depreciation is put into a deferred tax reserve account by the utility.

Not involved in this proceeding is the accounting method used by the utility for calculating depreciation as a separate, non-tax expense to be reflected in establishing rates.

so, would have to use either straight-line accounting or, with Commission approval, the normalization method (Pet. App. B1–B2). The Commission restated what it had theretofore found to be the case, *i.e.*, that "[n]ormalization results in a sharing of * * * tax benefits by consumers and regulated companies" (Pet. App. B2).[3] Accordingly, it announced that electric and natural gas pipeline companies electing to abandon the flow-through method with respect to post-1969 expansion property in accordance with the statute would be permitted to use the normalization method with respect to such property (Pet. App. B4).

In denying applications for rehearing, the Commission noted that Section 441(a) of the 1969 Act had given companies an absolute right to change from accelerated depreciation with flow-through to straight-line depreciation with respect to specific properties, and that regulatory agencies are powerless to vitiate that right by imputing the use of liberalized depreciation with flow-through and flowing the imputed (but not actual) tax benefits through to customers (Pet.

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[3] *In Alabama-Tennessee Natural Gas Co.*, 31 FPC 208, affirmed *sub nom. Alabama-Tennessee Natural Gas Co.* v. *Federal Power Commission*, 359 F. 2d 318 (C.A. 5), certiorari denied, 385 U.S. 847, the Commission initiated the policy now in effect of deducting the deferred tax reserve from the rate base so that no return on the tax savings from the use of liberalized depreciation is included in the company's rates. A utility's customers thus benefit indirectly from the use of liberalized depreciation with normalization, since the reserve provides the utility with capital for the expansion of facilities or the improvement of service at no cost to the customers.

App. B6).[4] Under these circumstances the Commission concluded that once a utility exercised its right of election under Section 441(a) of the Act, the Commission's only choice was to decide whether it should require the utility to remain on straight-line depreciation or whether it should permit the utility to use liberalized depreciation with normalization (Pet. App. B6). Given this choice, the Commission reaffirmed its conclusion that liberalized depreciation with normalization was preferable (Pet. App. B7–B8).

On petition for review, the court of appeals upheld the Commission's Orders Nos. 404 and 404–A, agreeing that the Commission's only choice after an election is made with respect to post-1969 expansion property is either to require the use of straight-line depreciation or to permit the use of liberalized depreciation with normalization (Pet. App. A4–A13).[5]

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[4] Prior to the 1969 Act, the Commission could impute the use of liberalized depreciation with flow-through to utilities that had elected to change to straight-line depreciation for tax purposes. *Midwestern Gas Transmission Co.* v. *Federal Power Commission*, 388 F. 2d 444, (C.A. 7), certiorari denied, 392 U.S. 928. Such an imputation, of course, provided a compelling incentive to the utility to switch back to liberalized depreciation for tax purposes. Under the 1969 Act, however, once a utility elects under Section 441(a) to switch to straight-line depreciation, it is foreclosed from reverting to liberalized depreciation with flow-through.

[5] In consolidated appeals, the court of appeals reversed two Commission orders permitting the Texas Gas Transmission Corporation to switch from liberalized depreciation with flow-through to liberalized depreciation with normalization with

ARGUMENT

The court below correctly construed Section 441(a) of the Tax Reform Act of 1969 to foreclose the Commission from imputing to a utility with respect to post-1969 expansion property the use of liberalized depreciation with flow-through for the purpose of calculating the allowance for federal income taxes in ratemaking, where the utility had elected under Section 441(a) of the Act not to have liberalized depreciation with flow-through apply to such property for tax purposes. Accordingly, no further review of this aspect of the decision below is warranted.

1. The legislative history of Section 441(a) of the 1969 Act makes clear that the election provision was intended to give a utility the absolute right to abandon liberalized depreciation with flow-through with respect to post-1969 expansion property and to foreclose a regulatory agency from imputing liberalized depreciation with flow-through where such an election is made. The election provision was first proposed in the Senate to apply to all utility property. The Senate report states (S. Rep. No. 91–552, 91st Cong., 1st Sess., pp. 173–174) that the provision would permit a utility

> * * * to shift from the flow-through to the straight-line method, with or without the permission of the appropriate regulatory agency, or permit it with the permission of the regula-

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respect to its pre-1970 property and its post-1969 non-expansion property (Pet. App. A13–A23). The government intends to file a petition for a writ of certiorari to review this aspect of the decision below.

> tory agency to shift to the normalization method (that is, to come under general rules of the bill).

The report further states (*ibid.*) that since, after the election,

> * * * the company would no longer be permitted to use accelerated depreciation (unless the agency later permits it to normalize), *the agency would not be able to impute the use of accelerated depreciation with flow-through.* In other words, a company that makes this election would be under the general rule of the bill after its election takes effect. [Emphasis supplied.]

In conference, the right of election was restricted to post-1969 expansion property (see H. Conf. Rep. No. 91–782, 91st Cong., 1st Sess., pp. 312–313), but the absolute nature of the right was not limited. The above-quoted statement in the Senate report thus remains the clearest expression of legislative intent available and squarely supports that aspect of the decision below challenged in the present petition.

Petitioner cites (Pet. 7–8) language in the House and Senate reports to the effect that Section 441(a) was intended to freeze existing utility depreciation practices, thus preventing the loss of further tax revenues through shifts from straight-line to liberalized depreciation while at the same time forestalling the need for rate increases by *not* requiring those utilities on flow-through to abandon that method of accounting. This general reference to a "freeze," however, does not negate the specific election provision adopted by

Congress to permit utilities to abandon flow-through with respect to post-1969 expansion property nor the express language of the Senate report interpreting the election provision.

The Senate report on the election provision also notes that, once a utility has made the election, it may use accelerated depreciation only "so long as it continues to normalize; if not, the company must use only straight-line depreciation." S. Rep. No. 91–552, *supra,* pp. 173. See 26 U.S.C. 167(*l*)(2)(B) of the Act. If, as petitioner urges, a regulatory agency imputed flow-through for ratemaking purposes to a company which had irrevocably elected to abandon flow-through, the operation of the Tax Reform Act would force the utility into straight-line depreciation for tax purposes. The utility would thus be trapped into a situation where it would be paying higher taxes than it could recover in calculating its cost of service for ratemaking purposes on its post-1969 expansion property.

2. The decision below is not inconsistent with the pre-Tax Reform Act decision in *Midwestern Gas Transmission Co.* v. *Federal Power Commission, supra,* holding that the Commission could impute the use of liberalized depreciation with flow-through to utilities that had elected to change to straight-line depreciation for tax purposes. Prior to the Act, a utility changing to straight-line depreciation for tax purposes was not precluded from switching back to accelerated depreciation with flow-through. The imputation of this method by the Commission for calcu-

lating the tax allowance for ratemaking purposes provided a strong incentive to switch back to the same method for tax purposes. Under the 1969 Act, however, once an election is made no reversion to accelerated depreciation with flow-through is possible.

The Tax Reform Act and its history clearly reflect that Congress was well aware of the implications of permitting regulated utilities to elect to abandon liberalized depreciation with flow-through with respect to post-1969 expansion property. As the court below stated (Pet. App. A9), "* * * the FPC was not remiss in the performance of its statutory duty in permitting [a utility] to abandon flow-through in regard to its post-1969 expansion property, as expressly provided by the language of Section 441(a) of the Tax Reform Act."

CONCLUSION

For the foregoing reasons, the petition for a writ of certiorari should be denied.

Respectfully submitted.

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